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Carl Kaminski

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Online Peer-to-Peer Payments: PayPal Primes the Pump, Will Banks Follow?

As more businesses and individuals turn to the Internet to buy and sell goods, new peer-to-peer payment systems have developed to make these transactions possible.¹ A peer-to-peer payment system allows one person or entity to transfer money to another.² The most common of these payment systems are checks and credit cards, but the growth of Internet commerce and the unique demands of the online marketplace have spurred the development of new Internet payment systems.³ While credit cards are useful for making purchases from online merchants, individuals and many small businesses cannot accept credit card payments.⁴ Checks are not useful in the online market place where buyers and sellers are often unable to determine the reliability or even the identity of each other.⁵ Making payments by check often causes delays as shipments are held up until a check clears.⁶ Therefore, a market for Internet peer-to-peer payment systems that are convenient, fast, reliable and safe has emerged.⁷

Online auctions, in particular the online auction giant eBay, Inc. (eBay), provided the environment for the development of the first online peer-to-peer payment systems.⁸ In online auction transactions the buyer and seller usually do not have any sort of prior relationship, and often the seller is not a merchant capable of

1. Jeffrey P. Taft, *Internet-Based Payment Systems: An Overview of the Regulatory and Compliance Issues*, 56 CONSUMER FIN. LAW QUARTERLY REPORT 42 (2002).

2. Joseph I. Rosenbaum, *Preparing for the World of E-Payments; Practice of Electronic Money Transfers Gains Respectability – And Scrutiny*, N.Y. L.J., June, 10, 2002, at S8, available in LEXIS, News Library, ABBB File. This article discusses person-to-person payments. However, because the scope of this Note goes beyond transactions between individual people, the term peer-to-peer will be used.

3. *Id.*

4. *Id.*

5. *Id.*

6. Taft, *supra* note 1, at 42.

7. Rosenbaum, *supra* note 2.

8. Taft, *supra* note 1, at 42.

accepting credit card payments.⁹ PayPal, Inc. (PayPal), has emerged as the leader in the auction market by allowing individuals and small businesses to move funds from bank accounts, credit cards or a special PayPal money market account to anyone with an email address.¹⁰ eBay announced on July 8, 2002, that it planned to purchase PayPal.¹¹

On October 3, 2002, a majority of PayPal's 61.1 million outstanding shares were voted in favor of the \$1.3 billion merger with eBay.¹² Although it has not been without its headaches,¹³ the all-stock acquisition is expected to benefit both eBay and PayPal.¹⁴ PayPal, "which makes money by moving money between buyers and sellers on the Internet,"¹⁵ generates about two-thirds of its revenues from eBay auction transactions.¹⁶ About forty percent of eBay transactions are settled with electronic payments, seventy percent of which are through PayPal.¹⁷ After the merger both

9. *Id.*

10. Rosenbaum, *supra* note 2.

11. Taft, *supra* note 1, at 42.

12. Bob Porterfield, *PayPal Shareholders OK eBay Merger*, ASSOCIATED PRESS ONLINE, Oct. 3, 2002, available at 2002 WL 101073053.

13. See *infra* notes 183-188 and accompanying text for a discussion of several shareholder lawsuits challenging the merger.

14. Virgil Larson, *Mountain View, Calif.-Based PayPal Has High Hopes for eBay Boost*, OMAHA WORLD-HERALD, Sept. 8, 2002, at 1D, available at 2002 WL 26639743.

15. *Id.* eBay announced that in the week following PayPal's integration into the eBay site, PayPal's total payment volume increased ten percent. Mary Anne Ostrom, *Ebay Outlines Ambitious Growth Goals; 3-Part Strategy Aims at \$3 Billion Revenue*, SAN JOSE MERCURY NEWS, Oct. 31, 2002, at A3. PayPal generates income through transaction fees and by earning interest on funds held for others. PayPal, Inc., Form 10-Q: Quarterly Report On Form 10-Q, Second Quarter, 2002, at 27, (filed Aug. 6, 2002) available at <http://www.sec.gov/Archives/edgar/data/1103415/000091205702030120/a2085776z10-q.htm> (last visited Feb. 15, 2003) [hereinafter Form 10-Q]. More than ninety-nine percent of PayPal's revenues are generated through transaction fees because PayPal has moved customer funds into non interest-bearing agency accounts in an effort to obtain pass-through Federal Deposit Insurance Corporation (FDIC) insurance for its customers' funds. *Id.* PayPal charges its business and premier account holders for the receipt of funds. PayPal, Fees, at <http://www.paypal.com/cgi-bin/webscr?cmd=p/gen/fees-outside> (last visited Feb. 15, 2003). To receive credit card payments, PayPal customers must open either a business or premier account. *Id.* PayPal charges business and premier account holders between 0.7 percent of the amount transferred plus thirty cents and 2.9 percent of the amount transferred plus thirty cents per transaction to receive funds. *Id.*

16. Porterfield, *supra* note 12.

17. Larson, *supra* note 14.

parties expect those numbers to rise.¹⁸ PayPal will continue to operate as an independent brand and will seek to expand its presence in the auction market and beyond.¹⁹ It expects to benefit from the merger by removing one of its chief competitors, eBay-owned Billpoint (also known as eBay Payments), and by becoming eBay's preferred payment service.²⁰ The online auction giant expects to benefit by saving an estimated \$10 to \$15 million it was losing on Billpoint, which had failed to keep up with PayPal, and by adding PayPal's revenue to its bottom line.²¹

By taking advantage of the tremendous growth of eBay and other Internet auction sites²² PayPal has grown quickly since it was launched in 1999.²³ The company now offers its services to more than 20 million users in thirty-eight countries.²⁴ Before the eBay merger PayPal had estimated that for the fiscal year ending December 31, 2002, revenues could range from \$222 million to \$230 million and that after-tax net income for the year could range from \$22 million to \$24 million.²⁵ PayPal also estimated that its payment volume for the year could range from \$6.55 to \$6.75 billion.²⁶ eBay expects PayPal to contribute between \$60 and \$64 million in net revenues in the fourth quarter of 2002.²⁷

18. *Id.*

19. *Id.* Former PayPal chief executive officer, Peter Theil, "envision[s] a push to build the nonauction side of PayPal's business as eBay users become acquainted with PayPal and begin to use its services in other areas. Examples: to pay for other Internet purchases, or to email money to a child in college." *Id.*

20. *Id.*

21. *Id.*

22. David E. Sorkin, *Payment Methods for Consumer-To-Consumer Online Transactions*, 35 AKRON L. REV. 1 (2001).

23. PayPal, About Us, at <http://www.paypal.com/cgi-bin/webscr?cmd=p/gen/about-outside> (last visited Feb. 15, 2003) [hereinafter PayPal, About Us].

24. *Id.*; see also Deborah Bach, *eBay Goals for PayPal: Expansion, Subtraction*, AM. BANKER, July 9, 2002, at 1. "eBay transactions make up about sixty percent of PayPal's gross payment volume." *Id.*

25. Press Release, PayPal, State of New York Finds PayPal Is Not Engaged in Banking; PayPal Also Announces It Is On Track to Meet Previous Estimates of Second-Quarter Results (June 12, 2002), available at http://www.paypal.com/cgi-bin/webscr?cmd=_ir-release&rid=305363 (last visited Feb. 15, 2003).

26. *Id.*

27. Press Release, PayPal, eBay Completes PayPal Acquisition (Oct. 3, 2002), available at http://www.paypal.com/cgi-bin/webscr?cmd=_ir-release&rid=340828 (last visited Feb. 15, 2003).

PayPal has survived numerous lawsuits and regulatory disputes, and it remains a profitable pioneer in the online peer-to-peer payment market. PayPal has plans to expand and has declared that it seeks “to become the global standard for online payments.”²⁸ Some industry observers, however, think the eBay merger has created an opportunity for competitors, including banks and credit card companies, to stake out territory in the online peer-to-peer payment field that PayPal has dominated.²⁹ PayPal has proven that there is a market for peer-to-peer online payment systems, and industry observers expect that market to grow.³⁰ It will be up to PayPal’s would-be competitors to determine just how much of that projected growth they will capture.

Part I of this Note will discuss the services PayPal provides.³¹ Part II of this Note will discuss some of the regulatory obstacles PayPal has overcome and the uncertainties that are still looming.³² Part III will examine the explanations for the failures of many of PayPal’s early rivals, and it will look at some of the more recent attempts to establish Internet peer-to-peer payment services, including those involving banks and credit card companies.³³

I. PAYPAL AND ITS SERVICES

PayPal enables any business or consumer with an email address to establish an account that can be used to send and receive payments from bank accounts and credit cards online.³⁴ It allows individuals and small businesses that otherwise would not be able to accept a credit card payment to do so,³⁵ and it permits

28. PayPal, About Us, *supra* note 23.

29. Pete Barlas, *Yahoo Looks to Online Payment Bonanza*, INVESTOR’S BUS. DAILY, July 26, 2002, at A4.

30. *Id.* “The value of peer-to-peer payments in the U.S. will reach \$13.2 billion by 2006 vs. \$1.9 billion last year, says market tracker Jupiter Media Metrix Inc.” *Id.*

31. *See infra* notes 34-46 and accompanying text.

32. *See infra* notes 47-188 and accompanying text.

33. *See infra* notes 189-206 and accompanying text.

34. PayPal, About Us, *supra* note 23.

35. *See* Sorkin, *supra* note 22, at 7.

online purchasers to engage in transactions “without mailing a check or sending a credit card number to an unknown person or Web site.”³⁶ With PayPal a buyer will never have to disclose bank account or credit card information to a seller because “PayPal provides the parties with little to no information about one another other than that which the parties choose to disclose.”³⁷ PayPal funds a customer’s payment request by charging that customer’s bank deposit account or credit card account, using account information that the customer has provided to PayPal.³⁸ PayPal then sends an email to the receiving party stating that it is holding funds in the receiving party’s name that can be redeemed by check or electronic fund transfer.³⁹

PayPal’s business model offers five options for the payment and receipt of money.⁴⁰ The options, described in PayPal’s User Agreement,⁴¹ are: (1) placing funds into an account at a bank that the customer can access by either a physical⁴² or virtual debit

Generally, credit cards are extremely popular for Internet commerce and are favored by consumer protection officials and advocates because of the protections that they provide. Yet credit card payments enjoy a much smaller market share in online auctions largely because many sellers are individuals rather than businesses, and it is difficult and often impractical for individuals to obtain merchant accounts that enable them to accept payments by credit card.

Id.; see also Barlas, *supra* note 29. Credit card companies typically charge much higher rates than PayPal. *Id.* Therefore, it is often more convenient and less expensive for a small business to use PayPal, rather than to set up a credit card account. *Id.*

36. Lee S. Adams & David J. Martz, *Developments in Cyberbanking*, 57 BUS. LAW. 1257, 1272 (2002).

37. Sorkin, *supra* note 22, at 12.

38. See Adams & Martz, *supra* note 36, at 1272-73 (describing the general method used by email payment systems, of which PayPal is recognized as the industry leader).

39. *Id.*

40. Scott A. Anenberg, *Selected Regulatory Developments: New York Gives Green Light to PayPal; Hong Kong Authorities Voice Reservations*, ELEC. BANKING L. & COM. REP., July/Aug. 2002, at 24, available in LEXIS, News Library, ABBB File.

41. PayPal, User Agreement for PayPal Services, at <http://www.paypal.com/cgi-bin/webscr?cmd=p/gen/terms-outside> (last visited Feb. 15, 2003) [hereinafter PayPal, User Agreement].

42. *Id.* PayPal offers a co-branded PayPal MasterCard ATM/Debit Card to U.S. and select international PayPal users. *Id.* Cardholders can use their cards in offline transactions, including withdrawing cash and inquiring as to their PayPal account

card;⁴³ (2) a wire transfer by Wells Fargo Bank, on behalf of PayPal, to a bank account at a third-party bank in the name of the customer; (3) processing by Wells Fargo Bank of a check payable to the customer selling goods or services and forwarding it to that customer; (4) sweeping funds to purchase shares in the customer's name in the PayPal Money Market Fund;⁴⁴ and (5) pooling funds with other customer funds and placing them in a bank account denominated "PayPal, Inc., as agent for the benefit of its customers" at an FDIC-insured bank.⁴⁵ PayPal's business model has created a great deal of controversy in the banking regulatory community.⁴⁶

II. THE PERILS OF BEING PAYPAL

A. *Receipt of Deposits Without a Bank Charter*

In the days leading up to its initial public offering on February 15, 2002, PayPal disclosed that four states – California, Idaho, Louisiana and New York – were initiating investigations into whether or not PayPal was operating as a bank without a

balances at automated teller machines (ATMs) that are part of the MasterCard/Maestro/Cirrus ATM network, subject to certain limits. *Id.* Cash withdrawals are subject to a \$1.00 fee in addition to any fees assessed by the terminal owner. *Id.* The cards may also be used to purchase goods and services from merchants that accept MasterCard, up to the available balance in the PayPal account. *Id.*

43. *Id.* PayPal offers a "Virtual" MasterCard debit card number that customers can use to make online purchases. *Id.* Customers are given a sixteen-digit number and an expiration date that together can be used to access the balance of the account at online merchants that accept MasterCard. *Id.* The "Virtual" number will be different than the number of a plastic (i.e. "real") debit card issued by PayPal. *Id.* Also, the "Virtual" debit card is subject to a \$150 spending limit. *Id.*

44. PayPal, Safety of your Money, at <http://www.paypal.com/cgi-bin/webscr?cmd=p/gen/safety-outside> (last visited Feb. 15, 2003) [hereinafter PayPal, Safety of your Money]. Shares of the money market are offered through a partnership with Barclays Global Investors. *Id.* PayPal states that investments in the fund are not held by PayPal and are not PayPal investments. *Id.* Instead, the funds are held in the customer's name in the fund that, in turn, invests in a fund managed by Barclays Global Investors. *Id.* As of October 10, 2002, the fund's seven-day average yield was 1.79 percent. PayPal, Earn Money Market Returns, at <http://www.paypal.com/cgi-bin/webscr?cmd=p/gen/safety-outside> (last visited Feb. 15, 2003).

45. Anenberg, *supra* note 40, at 24.

46. *Id.*

license.⁴⁷ Regulators in those states were questioning whether PayPal's practice of allowing customers to leave money in prepaid accounts for use in future transactions constituted illegal banking.⁴⁸ Although the possible consequences vary from state to state,⁴⁹ if found to be operating illegally as a bank, PayPal would have to spend a great deal of time and money complying with strict capitalization and reporting rules.⁵⁰ Also, PayPal could face significant penalties, including fines or possibly being denied a license and therefore prevented from doing business in a state that found it to be violating its banking laws.⁵¹

The issue of whether PayPal was illegally banking by accepting deposits came up again when PayPal issued a Press Release on March 12, 2002,⁵² stating that it had received a final advisory opinion from the FDIC Legal Department stating that customer funds, which had been placed by PayPal in FDIC-insured banks,⁵³ were eligible for FDIC pass-through deposit insurance.⁵⁴ PayPal's web site states that pass-through insurance only protects deposits in the event of the failure of a bank in which PayPal has placed a customer's funds and not in the event of PayPal's insolvency.⁵⁵ Also, funds placed in the PayPal Money Market

47. Deborah Bach, *New PayPal Woe: States Say It Needs A Regulator*, AM. BANKER, Feb. 13, 2002, at 1.

48. *Id.*

49. Deborah Bach, *eBay: It's The Concept That's Being Scrutinized*, AM. BANKER, Apr. 8, 2002, at 1. "It's quite possible you could be a bank in one state, a money transmitter in another, and nobody in a third state." *Id.*

50. *Id.*

51. *Id.*

52. Press Release, PayPal, PayPal Receives FDIC Advisory Opinion on Insurance for Customer Funds, (Mar. 12, 2002), available at http://www.paypal.com/cgi-bin/webscr?cmd=_ir-release&rid=268046 (last visited Feb. 15, 2003) [hereinafter PayPal, PayPal Receives FDIC Advisory Opinion on Insurance for Customer Funds].

53. Federal Deposit Insurance Act, 12 U.S.C. § 1811 (2002). The Federal Deposit Insurance Corporation was established under the authority of the Federal Deposit Insurance Act "to insure, as hereinafter provided, the deposits of all banks and savings associations which are entitled to the benefits of insurance under this Act" 12 U.S.C. § 1811(a) (2002).

54. Deborah Bach, *In Brief: PayPal Covers Some PayPal Deposits*, AM. BANKER, Mar. 13, 2002, at 9.

55. PayPal, FDIC Pass-Through Insurance, at <http://www.paypal.com/cgi-bin/webscr?cmd=p/gen/fdic-outside> (last visited Feb. 15, 2003) [hereinafter PayPal, FDIC Pass-Through Insurance]. The FDIC opinion noted that the funds would be covered "as long as PayPal's role as agent for its customers is clearly disclosed on the

Fund are not eligible for FDIC insurance.⁵⁶ However, the Press Release added, "Through the terms of our User Agreement,⁵⁷ we believe that your funds will also be protected from any claims of PayPal's creditors and will be returned to you even in the unlikely event of a PayPal insolvency."⁵⁸ In the Press Release announcing the opinion letter, former PayPal CEO Peter Thiel stated:

While customers will continue to be able to request a withdrawal by check or electronic funds transfer at any time, those who do not immediately request a withdrawal have two attractive options: a nightly sweep into a money market fund where their funds earn a rate of return, or a deposit on their behalf at a financial institution where it is eligible for FDIC insurance.⁵⁹

Some industry observers believed that the FDIC's advisory opinion letter would lead to PayPal being regulated as a bank because it was accepting deposits.⁶⁰ PayPal asserted that the FDIC opinion letter would have the opposite effect and would help it in its efforts to avoid being declared a bank.⁶¹ PayPal had requested that the FDIC issue an opinion on whether it was "receiving deposits" for the purposes of the Federal Deposit Insurance Act (FDIA),⁶² but the FDIC refused to do so based on a literal reading

account records and PayPal maintains adequate records to identify how much of the funds belong to each customer on any given day." Scott A. Anenberg, *FDIC Addresses Deposit Insurance Issues Raised by PayPal*, ELEC. BANKING L. & COM. REP., Apr. 2002, at 19, available in LEXIS, News Library, ABBB File.

56. PayPal, FDIC Pass-Through Insurance, *supra* note 55. "The PayPal Money Market Fund is not FDIC insured, not guaranteed by any bank and may lose value." *Id.*

57. PayPal, User Agreement for PayPal Service, *supra* note 41.

58. PayPal, FDIC Pass-Through Insurance, *supra* note 55.

59. PayPal, PayPal Receives FDIC Advisory Opinion on Insurance for Customer Funds, *supra* note 52. As of March 12, 2002, PayPal has deposited its customers' funds at Wells Fargo Bank, Comerica Bank – California, and Bank of America. PayPal, FDIC-Insured Banks, at http://www.paypal.com/cgi-bin/webscr?cmd=p/pop/fdic_banks-outside (last visited Feb. 15, 2003).

60. Deborah Bach, *CEO Insists That PayPal Will Not Be Declared a Bank*, AM. BANKER, Mar. 19, 2002, at 1.

61. *Id.*

62. Anenberg, *supra* note 55, at 19.

of the FDIA, which defines a “deposit” as funds “received or held by a bank or savings association.”⁶³ PayPal is not chartered as a bank or savings association, therefore the FDIC said “the result is self-evident.”⁶⁴ However, the FDIC did note in the opinion that PayPal “does not physically handle or hold funds placed into the PayPal service.”⁶⁵ It is this language that PayPal seized upon: “We don’t consider ourselves to be a bank, the FDIC doesn’t consider us to be a bank, so we don’t expect there to be any significant regulatory load.”⁶⁶

On June 3, 2002, The State of New York Banking Department (NYBD) agreed with PayPal, concluding in an opinion letter that PayPal was not engaged in illegal banking.⁶⁷ Two earlier NYBD opinion letters had stated that “PayPal’s option under which payment money is kept on account for future use constitutes illegal banking.”⁶⁸ In its third letter the department reversed its position, largely in response to changes made by PayPal to its business model.⁶⁹ When the first two opinion letters were issued PayPal had been placing customer funds into a corporate account, but when the third letter was issued, PayPal had begun offering to its customers two different options: “sweeping funds to purchase shares in the customer’s name in the PayPal Money Market Fund or pooling the funds with other customer funds and placing them in a bank account at . . . one or more FDIC-insured banks” (pooled accounts).⁷⁰ The pooled account funds were not carried on PayPal’s balance sheet and were held in non-interest bearing accounts from which PayPal derived no monetary benefit.⁷¹

63. 12 U.S.C. § 1813(1)(3) (2002).

64. Anenberg, *supra* note 55, at 19.

65. *Id.*

66. Bach, *supra* note 60 (quoting former PayPal CEO Peter Theil).

67. Opinion Regarding PayPal Activities, 2002 N.Y. Bank. LEXIS 1 (June 3, 2002) [hereinafter PayPal Opinion].

68. 2000 N.Y. Bank LEXIS 1 (July 18, 2000), *aff’d* by 2001 N.Y. Bank LEXIS 1 (Jan. 10, 2001). The practice of deposit-taking by a non-banking corporation violates New York law. N.Y. BANKING LAW § 131 (2002).

69. PayPal Opinion, *supra* note 67.

70. *Id.* If a customer did not select an option, then the funds were placed in one of the pooled accounts. *Id.*

71. *Id.*

The June 3, 2002 NYBD opinion letter was written in response to a letter from PayPal dated March 7, 2002 supporting PayPal's position that the alterations in its business model resolved the NYBD's concerns over its practices.⁷² PayPal pointed out that the PayPal Money Market Fund is an independent entity from PayPal and that the funds are not carried on PayPal's balance sheet.⁷³ PayPal also noted that its User Agreement⁷⁴ states that PayPal is only the customer's agent with respect to funds in the pooled accounts and that because it had been acting only as an agent, the FDIC concluded that the funds were eligible for pass-through insurance.⁷⁵ PayPal also cited New York case law in support of the position that acting as an agent in a banking transaction is distinguishable from acting as a banking institution and that PayPal was indeed acting as such an agent.⁷⁶

The NYBD agreed and determined that PayPal, under its revised business model, was acting as an agent and not as a banking institution.⁷⁷ The NYBD did, however, express concern that PayPal was operating essentially free from national or state supervision.⁷⁸ The NYBD advised PayPal that it should apply for a New York money transmitter license as soon as practicable.⁷⁹ In

72. *Id.*

73. *Id.*

74. PayPal, User Agreement, *supra* note 41. The PayPal User Agreement states, in pertinent part: "You acknowledge that (i) PayPal is not a bank and the Service is a payment processing service rather than a banking service, and (ii) PayPal is not acting as a trustee, fiduciary or escrow with respect to your funds, but is acting only as an agent and custodian." *Id.*

75. PayPal Opinion, *supra* note 67. The FDIC opinion stated that pass-through coverage was contingent on PayPal's agency role being clearly disclosed on the bank account records. *Id.*

76. *Id.* PayPal's letter cited *Independent Bankers Association of New York State, Inc. v. Marine Midland Bank, N.A.*, 583 F.Supp. 1042 (W.D.N.Y. 1984). *Id.* The court in *Independent Bankers* held that a supermarket that operated an ATM through which a bank could transact business with customers was acting as an agent for the bank and not as a banking institution. *Id.* at 1049. The court added that ownership of the ATM was not a determining factor and the fact that the supermarket owned the ATM did not constitute banking. *Id.* In that case, the supermarket was responsible for loading the ATM with cash, and ATM transactions were processed by crediting the supermarket's account with the bank plus a small fee paid by the bank to the supermarket. *Id.* at 1044-45.

77. PayPal Opinion, *supra* note 67.

78. *Id.*

79. *Id.*

June 2002, PayPal applied for the New York money transmitter license.⁸⁰

B. Regulation as a Money Transmitter

According to New York state case law, a money transmitter, “as the name rather strongly implies, is in the business of sending money: collecting it from customers and, for a commission, delivering it to a designated recipient.”⁸¹ In the first of the opinion letters sent to PayPal from the NYBD, Assistant Counsel Steven Barras stated:

The intent of the New York legislature was to, among other things, minimize the risk of loss to New York customers who utilize third parties to transmit funds and ensure that persons and entities which engage in money transmission activities do not utilize their services to facilitate the conduct of illegal activities.⁸²

Barras concluded that PayPal’s business model addressed the concerns of the New York legislature, and despite the fact that by holding customer funds on account for later use PayPal was acting illegally as a bank, PayPal would not need to obtain a New York money transmitter license to offer its other services to New York residents through the Internet.⁸³ The attitude of the NYBD changed in its third letter in which it stated that PayPal was not illegally banking but would need to obtain a money transmitter

80. Form 10-Q, *supra* note 15, at 19.

81. *United States v. Cambio Exacto, S.A.*, 166 F.3d 522, 524 (2nd Cir. 1999); *see also* N.Y. BANKING LAW §§ 640 to 652b (2002). Most states with money transmitter regulations define the term broadly enough to cover online payment systems even though the laws predate the new entities. Taft, *supra* note 1, at 42-43.

82. 2000 N.Y. Bank LEXIS 1 (July 18, 2000).

83. *Id.* Barras wrote that by restricting the methods of payment to credit cards and bank account debits, PayPal was adequately addressing the concerns of the legislature. *Id.* The letter stated that the Federal oversight already in place to regulate credit card payments and bank account debits offered substantial protection to customers and would suffice to minimize the risk that the PayPal system would be used for illegal purposes. *Id.*

license due to concerns over the unregulated and evolving nature of PayPal's service and the fact that PayPal had plans to establish a physical presence in New York.⁸⁴

New York's change of heart reflected a growing uneasiness with the lack of regulation afforded Internet companies during the dot com boom.⁸⁵ James Van Dyke, a research director at the New York consulting firm Jupiter Media Metrix, Inc., was quoted as saying that regulators tended to take a hands off approach early on during the dot com boom and continued to do so as the companies began to slide.⁸⁶ However, he said the recent Enron Corporation scandal and signs of an economic recovery have prompted many regulators to act.⁸⁷

In Securities Exchange Commission (SEC) documents filed on August 6, 2002, PayPal disclosed that it had applied for money transmitter licenses in twenty-eight jurisdictions.⁸⁸ According to the report, at that time PayPal had obtained a money transmitter license in twelve states and the District of Columbia.⁸⁹ Also, at least eight other states have notified PayPal that the company does not need a money transmitter license to continue operating in their jurisdictions.⁹⁰ Today, forty-four states have enacted money transmitter laws.⁹¹ For example, North Carolina's Money Transmitters Act became effective on Nov. 1, 2001.⁹² Under the act, PayPal must obtain a license because it "makes available, from a location inside or outside [North Carolina], an Internet website North Carolina citizens may access in order to enter in [money transmitter] transactions by electronic means."⁹³ The North Carolina Act is broader than most other states' money transmitter laws because it requires any non-bank operator of an online

84. PayPal Opinion, *supra* note 67.

85. Bach, *supra* note 47, at 18.

86. *Id.*

87. *Id.*

88. Form 10-Q, *supra* note 15, at 50.

89. *Id.*

90. Linda Punch, *PayPal Under The Microscope*, CREDIT CARD MGMT., Aug. 2002 at 24, available at 2002 WL 20745318.

91. Bach, *supra* note 47, at 18.

92. N.C. GEN. STAT. § 53-208.1 (2002).

93. N.C. GEN. STAT. § 53-208.3 (2002).

payment system to obtain a license if it has customers in North Carolina.⁹⁴

Currently, the cost of money transmitter licenses ranges from \$1,500 to \$15,000, depending on the state.⁹⁵ However, if PayPal is found to be in violation of or is denied a money transmitter license in a jurisdiction where one is required, the consequences could be substantial.⁹⁶ As PayPal commented in its SEC filing:

If our pending applications [are] denied, or if we [are] found to be subject to and in violation of any money services laws or regulations, we also could be subject to liability or forced to cease doing business with residents of certain states or to change our business practices. Even if we are not forced to change our business practices, we could be required to obtain licenses or regulatory approvals that could impose a substantial cost on us.⁹⁷

In response to the concerns expressed by California, Idaho and Louisiana that PayPal was operating illegally as a bank, PayPal insisted that it was a money transmitter – not a bank – and then applied for money transmitter licenses in all three states.⁹⁸ In documents filed with the SEC, PayPal disclosed that by March 2002, after contacting PayPal and reviewing its new business model, regulators in Idaho and Louisiana had issued money transmitter licenses, and California had accepted PayPal's money transmitter license application for processing.⁹⁹ Thus, it appears that the question of whether PayPal is acting illegally as a banking

94. Taft, *supra* note 1, at 43.

95. Bach, *supra* note 47, at 18. North Carolina, for example requires applicants to pay a \$500 investigation fee as well as an annual license fee of \$1,000 plus \$10 for each location up to a possible total of \$5,000. N.C. GEN. STAT. § 53-208.9 (2002). Licensees also must post a surety bond of up to \$250,000. N.C. GEN. STAT. § 53-208.8 (2002).

96. Bach, *supra* note 47, at 1, 18.

97. Form 10-Q, *supra* note 15, at 50.

98. *Id.*

99. *Id.*

institution in the United States has largely been resolved.¹⁰⁰ In the United States it appears that PayPal will be regulated as a money transmitter rather than a bank.¹⁰¹

The most recent question regarding whether PayPal is a bank, a money transmitter, or something else entirely has come from the Banking Development Department of Hong Kong.¹⁰² Although it is certain to affect PayPal's ability to continue its overseas expansion, all the implications of Hong Kong's eventual decision are still uncertain.¹⁰³

C. *Compliance with The USA Patriot Act*

In addition to state money transmitter regulations, PayPal may soon have to spend significant amounts of money and other resources to comply with the USA Patriot Act.¹⁰⁴ Enacted forty-five days after the terrorist attacks on September 11, 2001, the USA Patriot Act is intended to give law enforcement powerful tools to fight the financing of terrorist activities.¹⁰⁵ Section 326 of

100. See *infra* notes 47-80 and accompanying text.

101. *Id.*

102. Deborah Bach, *Hong Kong Action May Harm PayPal Here, Abroad*, AM. BANKER, June 17, 2002, at 18.

103. Anenberg, *supra* note 40, at 24; see also Form 10-Q, *supra* note 15, at 20-21. In its quarterly filing, PayPal disclosed the following:

If [PayPal is determined to be "taking deposits" under Hong Kong's banking laws] then those laws require that any advertising material issued by [PayPal] to Hong Kong residents comply with Hong Kong law. . . . The Banking Ordinance would require [PayPal] to add certain additional information to the material on its Web site or risk a fine or imprisonment. . . . At this preliminary stage, [PayPal] believes that its service does not constitute "taking deposits" under the Hong Kong Banking Ordinance, and that even if it does, adding the information . . . to [its Web site] would not have a material adverse effect on [PayPal]. If, however, the Hong Kong Monetary Authority were to take the view that [PayPal's] service involved not only "taking deposits" but also taking those deposits in Hong Kong, then [PayPal] would likely need to be regulated as a bank in Hong Kong in order to allow Hong Kong customers to carry balances in the Agency Account. . . . An estimate of the range of loss, if any, related to these matters cannot be made at this time

Form 10-Q, *supra* note 15, at 20-21.

104. *Id.* at 51 (discussing the possible implications of the USA Patriot Act of 2001, Pub. L. No. 107-56, 115 Stat. 272).

105. Rosenbaum, *supra* note 2.

the USA Patriot Act requires the Secretary of the Treasury to prescribe regulations that, at a minimum, require “financial institutions” to implement reasonable procedures for:

(A) verifying the identity of any person seeking to open an account to the extent reasonable and practicable; (B) maintaining records of the information used to verify a person’s identity, including name, address, and other identifying information; and (C) consulting lists of known or suspected terrorists or terrorist organizations provided to the financial institution by any government agency to determine whether a person seeking to open an account appears on any such list.¹⁰⁶

On April 29, 2002, the United States Treasury Department issued an interim final rule for the implementation of § 326 of the USA Patriot Act.¹⁰⁷ However, in a press release issued on October 11, 2002, the Treasury Department advised all financial institutions that they will not be required to comply with § 326 of the USA Patriot Act until final implementing regulations are issued and become effective.¹⁰⁸ Under the USA Patriot Act, final regulations were to be implemented within one year of the enactment of the Act, on October 26, 2001.¹⁰⁹ However, on October 25, 2002, the Treasury Department issued a press release stating that the final regulations would be delayed and instead would be issued within the following six months.¹¹⁰

106. USA Patriot Act of 2001, Pub. L. No. 107-56 § 326, 115 Stat. 272 (codified as amended in 31 U.S.C. 5318).

107. Anti-Money Laundering Programs for Money Services Businesses, 67 Fed. Reg. 21114 (proposed Apr. 29, 2002) (to be codified at 31 C.F.R. § 103.125).

108. Press Release, U.S. Treas. Dept., PO-3530: Treasury Department Provides Guidance on Compliance with Section 326 of USA PATRIOT Act (Oct. 11, 2002), available at <http://www.ustreas.gov/press/releases/po3530.htm> (last visited Feb. 15, 2003).

109. USA Patriot Act § 326(a)(I)(6).

110. Press Release, U.S. Treas. Dept., PO-3580: Treasury Department Issues USA PATRIOT Act Guidance on Section 352 (Oct. 25, 2002), available at <http://www.ustreas.gov/press/releases/po3580.htm> (last visited Feb. 15, 2003).

PayPal has begun to work toward complying with the interim final rule, which specifically applied to money transmitters.¹¹¹ Under the interim final rule, each financial institution would have been required to create a program to implement comprehensive policies and procedures to detect fraud, maintain records, and respond to law enforcement requests; to designate a special compliance officer; and to train employees to detect suspicious transactions.¹¹² Each institution also would have been required to keep a written a copy of its plan available for inspection by the Treasury Department.¹¹³ PayPal has appointed a compliance officer and is training its new hires on the requirements of the USA Patriot Act.¹¹⁴ Also, PayPal officials have stated that because the company already uses sophisticated fraud-detection software,¹¹⁵ keeps records of every transaction, and closely monitors it users, it is well positioned to comply with the USA Patriot Act.¹¹⁶ Currently, PayPal files reports to the Treasury Department concerning all suspicious transactions greater than \$2000.¹¹⁷

Despite PayPal's confidence in its ability to meet the requirements of the USA Patriot Act, some lawyers who specialize in financial-services regulations have noted that the Act's record-keeping requirements may be so extensive as to pose an almost unbearable burden on smaller companies like PayPal.¹¹⁸ In fact, in an SEC filing PayPal reported: "These regulations could impose significant costs on us or make it more difficult for new customers to join our network. . . . These requirements could raise our costs significantly and reduce the attractiveness of our product."¹¹⁹

111. Yochi J. Dreazen, *Legislation Aimed at Stopping Terrorism Could Have a Devastating Impact on an Innocent Bystander: PayPal*, WALL ST. J., Oct. 21, 2002, at R9, available at 2002 WL-WSJ 3409314.

112. Anti-Money Laundering Programs for Money Services Businesses, 67 Fed. Reg. 21114.

113. *Id.*

114. Dreazen, *supra* note 111.

115. See *infra* notes 122-155 and accompanying text for a discussion of some of PayPal's aggressive anti-fraud procedures and the controversies surrounding them.

116. Dreazen, *supra* note 111.

117. *Id.*

118. See *id.*

119. Form 10-Q, *supra* note 15, at 51.

Depending on the severity of the forthcoming regulations, PayPal may have to add additional security and verification measures, especially on its foreign transactions.¹²⁰ Additional security measures in particular may cause PayPal headaches because its already aggressive stance toward investigating suspicious activity has been the subject of a great deal of criticism.¹²¹

D. Allegations that PayPal is violating the Electronic Fund Transfers Act by Illegally Seizing Customer Accounts When It Suspects Fraud

Although PayPal and other Internet payment systems are becoming more popular and widespread, concerns over fraudulent activity still plague the industry.¹²² PayPal faces a great deal of risk from Internet fraud, most notably through credit card transactions.¹²³ If a credit card is fraudulently used or if a cardholder disputes a charge, the amount of the transaction is usually charged back to PayPal.¹²⁴ In 2000, PayPal had \$8.9 million in chargebacks from unauthorized credit card use and was subsequently fined \$313,600 for excessive chargebacks by MasterCard International.¹²⁵ In 2001, PayPal had \$16.9 million in merchant-related disputes.¹²⁶ In SEC filings,¹²⁷ PayPal stated that its liability for chargebacks could cost it the right to accept credit card payments.¹²⁸ Since credit card payments make up about fifty percent of PayPal's transactions and have become a preferred method for making purchases at online auctions, PayPal would undoubtedly suffer if it were to lose the ability to take credit card payments.¹²⁹

120. See Dreazen, *supra* note 111.

121. See *infra* notes 122-155 and accompanying text.

122. Adams & Martz, *supra* note 36, at 1272.

123. Deborah Bach, *PayPal's \$81M IPO Filing Strikes Many as Ill-Timed*, AM. BANKER, Oct. 2, 2001, at 1.

124. *Id.*

125. Punch, *supra* note 90; Bach, *supra* note 123, at 6.

126. Punch, *supra* note 90.

127. *E.g.*, Form 10-Q, *supra* note 15.

128. *Id.* at 46.

129. See Punch, *supra* note 90.

Due to chargebacks and other security-related concerns,¹³⁰ PayPal has taken measures to prevent fraud.¹³¹ In 2000, the company lowered spending limits and developed its own anti-fraud software.¹³² PayPal also began the more controversial practice of seizing customer accounts whenever it suspected fraud.¹³³ Responding to the controversy, PayPal representatives have stated, “[s]ince we take protecting our network of customers very seriously, we choose to err on the side of caution when it comes to applying security measures – which may result in some accounts in good standing being affected.”¹³⁴ The practice of seizing accounts has resulted in a series of lawsuits alleging that PayPal is violating the Electronic Funds Transfer Act¹³⁵ and engaging in various other illegal business practices.¹³⁶ A significant amount of negative publicity and criticism has also resulted.¹³⁷ In SEC filings, PayPal disclosed that it is facing three class action lawsuits.¹³⁸

130. See Jan Jaben Eilon, *PayPal Plays It Safe; Pointing to security concerns, the company defends itself against one customer's allegations of a "bait-and-switch" tactic*, BANK TECH. NEWS, May 2002, at 7, available in LEXIS, News Library, ABBB File. One of the reasons for increased security measures at the PayPal site was an attack by Russian hackers in 2000. *Id.* The hackers stole credit card numbers, opened many PayPal accounts and sent payments to other PayPal accounts. *Id.*

131. *Id.*

132. *Id.*

133. Form 10-Q, *supra* note 15, at 47. “As part of our program to reduce fraud losses, we may temporarily restrict the ability of customers to withdraw their funds if those funds or their account activity are identified by our anti-fraud models as suspicious.” *Id.* “In certain cases, PayPal users will not be able to fund their payments using one of their funding sources registered to their account.” Eilon, *supra* note 130. PayPal lists numerous examples of events that will lead to its placing restrictions on a customer’s access to his or her account in the company’s User Agreement. PayPal, User Agreement, *supra* note 41.

134. Eilon, *supra* note 130.

135. Electronic Fund Transfer Act, 15 U.S.C.A. § 1693 (2002).

136. See Form 10-Q, *supra* note 15, at 60-61.

137. *Id.* at 53. In its Form 10-Q, PayPal noted that its practice of freezing customer accounts can damage its relationship with its customers and that it has received negative media coverage, as well as public criticism from the Better Business Bureau. *Id.* at 53. Several web sites have been launched that discuss customer complaints, including information about various class action lawsuits, and publish phone numbers that disgruntled customers can use to contact PayPal representatives. See, e.g., NoPayPal, at <http://www.paypalsucks.com> (last visited Feb. 15, 2003); PayPal Warning, at <http://www.paypalwarning.com> (last visited Feb. 15, 2003); AboutPayPal.org, at <http://www.aboutpaypal.org> (last visited Feb. 15, 2003); see also, *infra* notes 138-155 and accompanying text (discussing class action suits against PayPal).

138. Form 10-Q, *supra* note 15, at 60.

The first suit, *Comb et al. v. PayPal, Inc.*,¹³⁹ was filed on March 12, 2002, in the United States District Court for the Northern District of California, San Jose Division, on behalf of “all persons who, at any time since the launch of the PayPal service in October 1999, have opened an account with PayPal or had money electronically transferred from or to an account with another financial institution in connection with a PayPal transaction.”¹⁴⁰ The suit alleges that PayPal has:

(1) violated the Electronic Fund Transfer Act by, among other things, failing to conduct a good faith and timely investigation of errors reported by customers, failing to provisionally credit amounts alleged to be in error within ten business days, and failing to provide a telephone number and address readily available to the consumer for reporting unauthorized transactions; (2) converted funds of class members to [PayPal’s] own use through unlawful conduct; (3) transferred or retained from class members monies that [PayPal] had no right to retain; (4) unjustly retained monies belonging to the class members; and (5) been negligent in not making dispute resolution information readily available for customers, making it difficult for customers to resolve disputes with [PayPal] in an efficient and appropriate manner, and failing to establish and maintain adequate procedures concerning the transfer of funds.¹⁴¹

On August 30, 2002, a motion filed by PayPal to compel arbitration according to the terms of its User Agreement, which prohibits the consolidation of claims, was rejected.¹⁴² The agreement was found to be substantively unconscionable.¹⁴³ The

139. *Comb v. PayPal, Inc.*, No. C-02-1227 (N.D. Cal. filed Mar. 12, 2002).

140. Form 10-Q, *supra* note 15, at 61.

141. *Id.*

142. *Comb et al. v. PayPal, Inc.*, 218 F. Supp.2d 1165, 1175-77 (N.D. Cal. 2002).

143. *Id.* at 1177.

court held that the agreement placed PayPal customers in harshly unequal bargaining positions when they sought to make complaints because, in most cases, the cost of litigation would substantially outweigh the amount in dispute unless the consolidation of claims was allowed.¹⁴⁴ The court also found fault with the agreement's venue clause because of the substantial travel costs many potential litigants would incur in light of the small amounts often in dispute.¹⁴⁵

The second suit, *Lee et al. v. PayPal, Inc.*, was filed on June 6, 2002, in the Superior Court of California in Santa Clara County, on behalf of:

[A]ll persons who hold or [have] held PayPal accounts (a) that the Company restricted in their entirety, even though suspected frauds only implicate a portion of the funds in the accounts; (b) that the Company restricted without any reasonable ground to suspect user fraud or other justifiable basis, or (c) from which the Company deducted funds without justification, without completing an investigation.¹⁴⁶

The third suit, *Resnick et. al. v. PayPal, Inc.*,¹⁴⁷ was filed on June 10, 2002, in United States District Court for the Northern District of California, San Jose Division, on behalf of "all customers who use their PayPal account primarily for personal, family or household purposes."¹⁴⁸ PayPal's motion to compel arbitration in the *Resnick* suit was joined with a similar motion filed in the *Comb* suit, and both motions were denied when the court held the arbitration clause in PayPal's user agreement to be

144. *Id.* at 1176. "PayPal appears to be attempting to insulate itself contractually from any meaningful challenge to its alleged practices." *Id.*

145. *Id.* at 1176-77. The venue clause required that all arbitration take place in Santa Clara County, California. *Id.* at 1176. The average PayPal transaction involves just fifty-five dollars. *Id.* at 1175.

146. Form 10-Q, *supra* note 15, at 60.

147. *Resnick v. PayPal, Inc.*, No. C-02-2777 (N.D. Cal. filed June 10, 2002).

148. *Id.*

unconscionable.¹⁴⁹ The plaintiffs¹⁵⁰ in *Resnick*, like those in *Comb*, are alleging that PayPal has violated the Electronic Fund Transfers Act.¹⁵¹ The only material difference between the *Resnick* and *Comb* complaints appears to be the descriptions of the plaintiff classes.

PayPal states only that it believes it has meritorious defenses to these lawsuits and will continue to vigorously defend them.¹⁵² However, the lawsuits have the potential to significantly harm PayPal by taking up large amounts of time and money, and the damage to its reputation may already have been done.¹⁵³ Among the allegations is that “while PayPal has experienced a seven-fold increase in revenues and a thirteen-fold increase in users, it only has doubled the number of service representatives available to address customer concerns.”¹⁵⁴ Some investors have begun to question whether PayPal can make needed customer service improvements and still remain profitable.¹⁵⁵

E. Lawsuits alleging patent infringement

In September 2002, First USA Bank, N.A., a subsidiary of Bank One Corporation, filed a patent infringement lawsuit in the United States District Court of Delaware alleging that PayPal was infringing two business method patents relating to First USA’s Cardless Payment System.¹⁵⁶ The first patent deals with using personal identification numbers and telephone numbers as transaction identifiers, and the second broadens the scope of identification to email addresses.¹⁵⁷ First USA is seeking an injunction to prevent PayPal from using their system as well as

149. *Comb*, 218 F. Supp.2d at 1165-66.

150. Interestingly, the plaintiffs in *Resnick* and *Lee* share the same counsel. Form 10-Q, *supra* note 15, at 60.

151. *Id.* at 60-61.

152. *Id.* at 61.

153. *See, e.g., id.* at 53.

154. *Comb*, 218 F. Supp.2d at 1166.

155. Bach, *supra* note 102. “With all the problems that PayPal has faced – the lawsuits and the customer service issues – it just doesn’t send the best signal.” *Id.*

156. Ricardo Roberts, *First USA’s Gripe – Small Potatoes to eBay?*, MERGERS & ACQUISITIONS REP., Sept. 16, 2002, available at 2002 WL 8264830.

157. *Id.*

monetary damages.¹⁵⁸ PayPal has responded that it is not violating any patents, "although it has acknowledged the possibility of an intellectual property dispute over its core technology."¹⁵⁹ PayPal has stated that it believes the lawsuits are without merit and that it will defend against them vigorously.¹⁶⁰

First USA was not the first company to sue PayPal alleging patent infringement.¹⁶¹ On May 7, 2002, Tumbleweed Communications Corporation filed a lawsuit in the United States District Court for the Northern District of California claiming that PayPal was infringing on patents for document storage retrieval and electronic notification.¹⁶² PayPal and Tumbleweed have since settled their differences out of court.¹⁶³ Then, on February 4, 2002, two days before PayPal's initial public offering, CertCo., Inc., a New York-based company that describes itself as "a provider of risk management and security products and services for high-value, business-to-business transactions conducted over open networks,"¹⁶⁴ filed suit in the United States District Court of Delaware. CertCo alleged that PayPal was in violation of a patent covering payments and transactions in electronic commerce.¹⁶⁵ According to SEC filings, PayPal and CertCo settled their dispute on April 25, 2002 in an out of court settlement involving "an inconsequential payment by [PayPal] and mutual releases."¹⁶⁶

Although the patent infringement suits have forced PayPal to spend time and money addressing them, they have not stopped PayPal from becoming profitable nor have they interfered with the

158. *PayPal's Busy Days*, CREDIT CARD MGMT., Oct. 2002, at 10, available at 2002 WL 20745344.

159. Bob Porterfield, *PayPal Suits Shadow eBay Merger Bid*, ASSOCIATED PRESS ONLINE, Sept. 14, 2002, available at 2002 WL 100405011.

160. Roberts, *supra* note 156. "Scott Devitt, a Legg Mason Walker analyst, said, 'our expectation is that nothing will come of this,' and in the event PayPal had to settle or pay First USA, it would be too small to matter." *Id.*

161. See Form 10-Q, *supra* note 15, at 59. In its Form 10-Q, PayPal disclosed that it has been sued at least twice and threatened with suit on at least one other occasion. *Id.*

162. *Id.*

163. Roberts, *supra* note 156.

164. Deborah Bach, *Suit vs. PayPal Illustrates Power of Patent Holders*, AM. BANKER, Feb. 8, 2002, at 17.

165. *Id.*

166. Form 10-Q, *supra* note 15, at 59.

eBay merger.¹⁶⁷ In fact, most observers believe PayPal has little to fear, and it seems investors agree.¹⁶⁸

F. Getting Out of the Uncertain Internet Gambling Market

By early 2002, in pursuit of its goal to move beyond the auction market, PayPal had established itself in the online gambling industry offering its service for the settling of gambling debts.¹⁶⁹ In fact, in the first quarter of 2002, gambling-debt transactions accounted for eight percent of PayPal's transaction load, about \$117 million out of \$1.46 billion.¹⁷⁰ PayPal expected gambling transactions to increase, accounting for ten to fifteen percent of transactions in the next year.¹⁷¹

With 260 online gaming merchants signed on, New York Attorney General Eliot Spitzer declared that PayPal had become "the payment method of choice" for Internet gambling, which is illegal in New York.¹⁷² On July 5, 2002, Spitzer's office issued a subpoena seeking the production of documents related to PayPal's transactions with merchants involved in online gambling.¹⁷³ The stated purpose of the subpoena was to "assist the Attorney General in determining whether an action or proceeding should be instituted against [PayPal]."¹⁷⁴

167. See Roberts, *supra* note 156.

168. See *id.* On Feb. 19, 2002, the day of PayPal's initial public offering and only fifteen days after CertCo filed its complaint, PayPal shares opened at \$13 and closed at \$20.09. Bach, *supra* note 60.

169. Bach, *supra* note 24.

170. Larson, *supra* note 14.

171. *Id.*

172. PayPal's Busy Days, *supra* note 158; see also, *N.Y. v. World Interactive Gaming Corp.*, 714 N.Y.S.2d 844, 850 (1999) ("A computer server cannot be permitted to function as a shield against liability . . ."). Art. 1, § 9(1) of the New York State Constitution prohibits gambling not authorized by the state legislature. *World Interactive*, 714 N.Y.S.2d at 846. Also, under N.Y. PENAL LAW § 225.00(2), if a person engaged in gambling is located in New York, then the gambling transaction is deemed to occur in New York. *Id.* at 851. Therefore, the Supreme Court of New York has held that even if a gambling web site is set up and administered in a jurisdiction where gambling is legal, if the site allows people to gamble from computers within New York, the operator is violating N.Y. PENAL LAW § 225.05, under which a person is guilty of a criminal offense when he knowingly advances or profits from unlawful gambling activity. *Id.* at 850-851.

173. Form 10-Q, *supra* note 15, at 24-25.

174. *Id.*

On August 21, 2002, PayPal announced that it had reached a settlement with the New York Attorney General's office in which PayPal denied any wrongdoing, but agreed to quit processing New York customers' online gambling payments and to pay a \$200,000 fine to cover lost profits, investigation costs, and penalties.¹⁷⁵ PayPal has also reported that it has received two federal grand jury subpoenas issued by the United States District Attorney for the Eastern District of Missouri, both seeking the production of documents related to online gambling activities.¹⁷⁶ PayPal stated that it intends to fully cooperate with the U.S. Attorney General's office.¹⁷⁷

When it announced the acquisition of PayPal, eBay stated that due to the uncertain regulatory environment surrounding online gambling¹⁷⁸ it would sever all of PayPal's ties to online gambling sites.¹⁷⁹ Even though payments to online gambling sites made up between eight to ten percent of its payment volume at the time of the announcement,¹⁸⁰ former PayPal CEO Peter Thiel said that PayPal hoped to make up for the loss with the boost expected from the merger with eBay.¹⁸¹ Meg Whitman, eBay's CEO, said that despite the phase out of PayPal's gambling business, eBay estimates the acquisition will contribute \$60 to \$64 million to fourth quarter revenues in 2002.¹⁸²

G. *Shareholder Lawsuits Related to eBay Merger*

Since PayPal and eBay announced their merger on July 7, 2002, at least six shareholder groups have filed lawsuits hoping to

175. Steve Bills, *PayPal, N.Y. Settle Web Gambling Dispute*, AM. BANKER, Aug. 22, 2002, at 20.

176. Form 10-Q, *supra* note 15, at 24-25.

177. *Id.*

178. For a detailed discussion of the legality of online gambling, see Jon Patterson, *Internet Gambling and the Banking Industry: An Unsure Bet*, 6 N.C. BANKING INST. 665 (2002).

179. Linda Punch, *Are All Bets Off for Online Gambling?*, CREDIT CARD MGMT., Sept. 2002, at 14, available in LEXIS, News Library, ABBB File.

180. *Id.*

181. Larson, *supra* note 14.

182. Bob Porterfield, *Ebay Reports Record Quarter Profits*, ASSOCIATED PRESS ONLINE, Oct. 17, 2002, available at 2002 WL 101563242.

block the sale.¹⁸³ PayPal shareholders allege that PayPal officers are enriching themselves at the expense of smaller shareholders.¹⁸⁴ Under the terms of the merger agreement, PayPal shareholders will receive 0.39 shares of eBay stock for every PayPal share, and the shareholders think that price is too low.¹⁸⁵ At the time of eBay's offer that amount represented roughly an eighteen percent premium over the market value of PayPal shares, and the plaintiffs are complaining that the average premium in similar stock-for-stock mergers is thirty-eight percent.¹⁸⁶ Despite the lower than typical price eBay will be paying, PayPal officers will collectively end up reaping roughly \$600 million on paper.¹⁸⁷ PayPal has responded only that it "believes the lawsuits are without merit and intends to defend against them vigorously."¹⁸⁸

PART III: PAYPAL MAY SOON FACE STIFF COMPETITION FROM
BANK PEER-TO-PEER SERVICES THANKS TO AN EMERGING
THREAT FROM THE NORTH: CERTAPAY, INC.

Initially, when PayPal emerged and "seemed to illustrate a business case for [offering a peer-to-peer service]," the banking industry had high hopes for peer-to-peer payment transactions.¹⁸⁹ However, that enthusiasm faded quickly as banks found little demand for the service outside of Internet auctions like eBay.¹⁹⁰ In fact, after Bank of America, N.A., announced that it had ceased

183. Porterfield, *supra* note 12.

184. *Id.*

185. *Id.*

186. *Id.*

187. *Id.* If the stock stays near its level as of October 2, 2002, former PayPal CEO Elon R. Musk will receive nearly \$148 million worth of eBay stock; director Michael Moritz and his investment firm, Sequoia Capital, will collect \$111 million; former CEO Peter Thiel will receive almost \$58 million; and Max R. Levchin, PayPal's chief technology officer, will receive \$36 million. *Id.*

188. Form 10-Q, *supra* note 15, at 24.

189. Deborah Bach, *B of A Latest to Drop Plan For P-to-P Payments*, AM. BANKER, Mar. 12, 2002, at 1.

190. *Id.* at 17. Industry analysts have attributed the failure of most peer-to-peer online payment systems to a lack of acceptance, a lack of urgency and need, concerns over the security of internet transactions, and to the domination of PayPal in the auction market. John Adams, *Payments: P2P Takes Its Best Shot North of the Border; There's still some doubt, but Canada does look like a better bet*, BANK TECH. NEWS, Aug. 2002, available in LEXIS, News Library, ABBB File.

testing its peer-to-peer service and had no plans to develop it further, and Bank One Corporation announced that it was shelving its eMoney Mail service, only one major bank-owned PayPal competitor existed: Citigroup's c2it,¹⁹¹ which has been less focused on the domestic market and instead has been carving out a niche for itself in overseas transactions.¹⁹²

It appears, however, that a new system developed in Canada may renew the banking industry's interest in the peer-to-peer payment market.¹⁹³ CertaPay, Inc. (CertaPay), a Toronto based company, has developed E-Mail Money Transfers, a service that lets account holders at one of five Canadian banks¹⁹⁴ use email to send funds without including account information in the body of the email.¹⁹⁵ Using CertaPay, a user logs into a bank account and sends payments directly to a recipient's email.¹⁹⁶ In the email, a secret question only the sender and recipient will know, such as what someone ate for dinner the night before, is included.¹⁹⁷ When the recipient receives the email, he clicks on a link to his network bank, logs on to its web site, and gives the answer to the question, which will be encrypted in the email.¹⁹⁸ When this occurs the funds will instantly be transferred into the recipient's account and available immediately.¹⁹⁹ CertaPay believes that its real-time transfers give it an edge against PayPal.²⁰⁰

Furthermore, CertaPay has recently announced that it is working with NYCE Corporation (NYCE) to begin expanding

191. C2it, at <http://www.c2it.com> (last visited Feb. 15, 2003).

192. Bach, *supra* note 189; *see also*, Mark Bruno, *C2IT's Mexican Connection*, U.S. BANKER, Aug. 2002, at 17, available in LEXIS, News Library, ABBB File.

193. Deborah Bach & Chris Costanzo, *The Tech Scene: Why Canadian Banks See Potential in P-to-P*, AM. BANKER, July 17, 2002, at 1.

194. The banks included in CertaPay's network are Bank of Montreal, Bank of Nova Scotia, Toronto-Dominion Bank, Canadian Imperial Bank of Commerce, and Desjardins Group. David Breitkopf, *CertaPay Sees NYCE Deal As Key To U.S. P-to-P Market*, AM. BANKER, July 1, 2002, at 8.

195. *Id.*

196. Barlas, *supra* note 29.

197. Breitkopf, *supra* note 194.

198. *Id.*

199. *Id.*

200. *Id.* PayPal also uses email to notify recipients that funds are being sent, but those funds are first placed in a PayPal account and then transferred into the recipient's account. *Id.* Therefore, the transaction does not occur as quickly because the funds must clear before the recipient will be able to access them. *Id.*

into the U.S. market.²⁰¹ NYCE, headquartered in Woodlake, N.J., provides financial institutions and retailers with shared network services for ATM machines, online debit point-of-sale, and electronic benefits transfer transactions.²⁰² NYCE operates the NYCE Network, which is among the largest shared regional payment networks in the country.²⁰³ With access to the NYCE's Network of more than 2,200 financial institutions –which includes more than 1,000 banks in the United States – CertaPay believes it can convert peer-to-peer payments from a niche market into a mainstream offering.²⁰⁴ Also, NYCE cites research showing – despite the past failures of several banking institutions – there is significant demand for bank managed peer-to-peer payment systems.²⁰⁵ Together, they are hoping to create the catalyst for banks to enter the peer-to-peer payment market.²⁰⁶

PART IV: CONCLUSION

Since arriving on the scene in 1999, PayPal has proven itself to be a survivor. It has weathered controversies over whether its novel business model constituted internet banking, money transmission, or something else entirely,²⁰⁷ it has faced controversy over its involvement with online gambling web sites;²⁰⁸ it has faced several intellectual property lawsuits;²⁰⁹ and it is facing complaints

201. *Id.*

202. About NYCE, at http://www.nyce.net/about_NYCE.html (last visited Feb. 15, 2003).

203. *Id.*

204. Steven Marlin, *Person-to-Person Systems Go Prime Time*, BANK SYS. TECH, Sept. 1, 2002, at 42, available in LEXIS, News Library, ABBB File.

205. Neil Platt, *PayPal Threat Should Spur Bankers To Find P-to-P Payment Partners*, AM. BANKER, Apr. 19, 2002, at 7. “According to research conducted by NYCE and Dove Consulting, 57% of customers think that it is important for banks to offer [peer-to-peer] payments – and those consumers trust bank-based services over Internet-only services by 8 to 1.” *Id.*

206. Barlas, *supra* note 29. The CertaPay service will be available to all of the network banks, but it will be up to the banks to decide if they want to offer it. *Id.* “CertaPay partners with banks. . . . The pairing allows banks to offer CertaPay’s e-mail payment service to their customers. . . . it charges banks 16.2 cents for each transaction. Banks can charge whatever they want for the service” *Id.*

207. See *supra* notes 47-103 and accompanying text.

208. See *supra* notes 169-182 and accompanying text.

209. See *supra* notes 156-168 and accompanying text.

that its customer service and fraud protection services have been inadequate.²¹⁰ Despite being a magnet for controversy²¹¹ and having to deal with a poor economic environment for Internet-based ventures, PayPal surprised many critics with its success and continued growth.²¹² And after merging with online auction giant eBay, PayPal's bottom line looks as if it is going to get even better.²¹³

However, eBay's acquisition of e-commerce pioneer PayPal may have opened the door for others to follow PayPal's example.²¹⁴ Some analysts have stated that they think eBay will focus on using PayPal to improve service for eBay customers rather than on expanding PayPal's market share in the online payments business.²¹⁵ This potentially provides an opportunity for newcomers to challenge PayPal's dominance.²¹⁶ It will be interesting to see if banks will be willing to give peer-to-peer payments another shot. PayPal's example has shown that there is money to be made in online peer-to-peer payments,²¹⁷ and NYCE's research suggests that the market demands have not yet been met.²¹⁸ However, the sluggish economy and the difficulties in expanding significantly beyond the online auction market²¹⁹ may discourage new forays into the online peer-to-peer payment market.²²⁰

210. See *supra* notes 122-155 and accompanying text.

211. Roberts, *supra* note 156. "This always happens to them,' . . . referring to PayPal's numerous lawsuits." *Id.* (quoting an industry observer).

212. Mark Bruno, *PayPal Does Time in Investor Purgatory*, BANK TECH. NEWS, July 2002, available in LEXIS, News Library, ABBB File. In the face of criticism for testing the market at a bad time, and in spite of the filing of an intellectual property lawsuit against PayPal just days before its initial public offering on February 19, 2002, PayPal's stock performed better than expected and the company raised \$70 million in one of the top IPO's of the year. *Id.*

213. Ostrom, *supra* note 15.

214. Barlas, *supra* note 29.

215. *Id.*

216. *Id.*

217. Bach and Costonzo, *supra* note 193.

218. Platt, *supra* note 205.

219. Bach, *supra* note 24, at 6. When eBay acquired PayPal, more than sixty percent of PayPal's business derived from eBay auction transactions. *Id.*

220. Tyson Freeman, *E-pay investments dwindle*, THE DAILY DEAL, Oct. 11, 2002, available in LEXIS, News Library, ABBB File.

Banks would be wise to begin developing peer-to-peer services, if not to make an immediate profit, to stay relevant.²²¹ Banks have some significant advantages over companies like PayPal.²²² Banking institutions generally do not have to apply for licenses or meet any new requirements to offer money transmission services.²²³ As the intellectual property matters work themselves out, banks are in a position to team up with established companies like CertaPay and avoid the patent litigation and other intellectual property headaches that have plagued PayPal.²²⁴ Whether the United States banking industry will take advantage of the significant opportunities currently available in online peer-to-peer payments, or whether it will remain on the sidelines remains to be seen.

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221. Catherine Siskos, *Cash in a Flash*, KIPLINGER'S PERS. FIN., Oct. 1, 2002 at 30. Eventually [peer-to-peer] payments will replace personal checks, predicts Sanjeev Dheer, CEO of CashEdge, which helps banks set up [peer-to-peer] payment systems. People will use email to send money to a child in college, shift funds among their own accounts, or settle up a restaurant bill that is split among friends.

Id.; see also, Platt, *supra* note 205.

Customers are shifting assets out of their bank accounts to fund PayPal accounts.... And PayPal is looking more and more like a bank every day, offering credit and debit cards, money market accounts, small-business accounts, FDIC insurance, international payments, and online bill payment. . . . Bankers should be asking themselves how many bank customers are going to PayPal for a service they can't get at their bank.

Id.

222. Edward L. Neumann & Mary Beth Sullivan, *Viewpoints: Banks Should Position Themselves To Dominate Emerging Payments Biz*, AM. BANKER, Sept. 27, 2002, at 9. "... [E]very bank has a unique footprint and unique strengths. These include close ties to the customer base, brand recognition, technological capability, geographic focus, and product expertise." *Id.*

223. See, e.g., N.Y. BANKING LAW § 641(1) (2002) (creating an exception to money transmitter licensing requirements for banks and many other entities involved in banking).

224. Platt, *supra* note 205. "... [B]anks can partner with a private-label processor to fully integrate a service into the bank's Web site in a couple of months at a nominal cost." *Id.* By partnering with established money processors, banks can avoid the costs and risks associated with developing a new system while reaping what PayPal has demonstrated are substantial possible profits. *Id.*

